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TAGS: ECON EFIN ETRD ELAB EINV AR
SUBJECT: Plan B: Argentina Announces Robust Public Works, Tax Incentive Response to Economic Crisis

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Summary

¶1. (SBU) Argentine President Cristina Fernandez de Kirchner announced November 25 an ambitious US$21 billion public works plan to stimulate the economy, boost employment, and counter the impact on Argentina of the global financial crisis. She also proposed the creation of a new Ministry of Production and introduced a package of tax incentives to encourage local job creation and the repatriation of Argentines' funds from abroad (estimated at over $130 billion). While explaining the details of the proposals November 26, Cabinet Chief (and reportedly a key plan architect) Sergio Massa acknowledged that the economy is contracting so far in fourth quarter 2008, but claimed that these measures would result in real growth of 4% in 2009. Industry leaders, who have been most vocal in calling for GoA intervention -- including currency devaluation -- to maintain competitiveness, applauded the policy package, and a key GOA economic advisor characterized them to the Ambassador as "the most pro-business measures ever taken by either Kirchner government." However, most analysts reacted cautiously to the proposals, preferring to wait for more details to determine the potential impact of these initiatives on the economy. Many are skeptical about the potential impact of the tax incentives or possibility of attracting repatriated funds, and question how the GoA plans to finance the public works program, given that it has no access to credit and is facing a rapidly slowing economy and reduced commodity prices. End Summary.

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Plan B: Stimulus Package to Counter Economic Slide
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¶2. (SBU) In a widely anticipated move, on Tuesday, November 25, Argentine President Cristina Fernandez de Kirchner (CFK) announced the GoA's multifaceted attempt to arrest the rapidly slowing economy and rising industrial sector unemployment. In separate speeches to industry leaders and construction company representatives, she announced the creation of a new Ministry of Production, presented her draft bill to the Argentine Congress to establish tax incentives aimed at creating jobs and repatriating funds held overseas, and announced a US$ 21 billion (roughly 6% of 2008 GDP) public works program.

¶3. (SBU) CFK announced this ambitious sounding plan after months of official resistance to the need to address the spillover of the world economic crisis on Argentina. During the President's trip to New York in September for the UN General Assembly meeting, she had even denied that the international financial crisis would really affect Argentina, claiming that it was the problem of other

countries and Argentina had no need of a "Plan B" stimulus program. With domestic consumption plunging, economic activity coming to a screeching halt, and companies looking to lay off workers, local media widely interpreted these announcements as the GoA giving in to the need for a Plan B. Indeed, while commending the success of the Kirchner economic model to date, she made it clear that the GoA is ready to do whatever it takes to make sure that "those sectors most vulnerable [will not] be affected by the crisis."

¶4. (SBU) In her November 25 remarks during a lunch with the Argentine Industrial Union, CFK explained the details of the GoA's draft tax moratorium bill (sent to Congress the same day). She stated that companies creating new jobs would be given tax breaks for bringing on new hires and declaring and regularizing "informal" employees. With regards to the repatriation of funds, which the GoA estimates in the range of $130 billion (most of which are undeclared to GoA tax authorities), the President noted that companies or individuals that declare funds abroad, but do not repatriate them, will face an 8% tax rate under the new law. However, repatriated funds placed in the local financial system would pay only a 6% tax rate, and would face only a 3% tax rate if invested in government bonds or 1% tax rate if invested in new real estate, infrastructure, or industrial ventures.

¶5. (SBU) She also announced that the GoA was accelerating the process of splitting the current Ministry of Economy and Production into two in order to establish a stand alone Ministry of Production. (The GoA established these ministerial changes in a special decree sent to Congress November 26.) The new ministry will focus on the promotion of Argentine industrial production and exports, and will be headed by the current Minister of Production of Buenos Aires Province, Debora Giorgi (who is well-known to Post). The President

swore in Giorgi as the new GoA Minister of Production November 26.

¶6. (SBU) During a subsequent speech Tuesday evening before the Argentine Construction Chamber, CFK announced the launching of a more than 71 billion peso (US$21bn) multi-year public works program to stimulate the economy and alleviate the impact of the global economic crisis on Argentina's economy. She stated that the details of this proposal, which she called the "most ambitious public works plan" in recent memory, would be unveiled on December 15. Nevertheless, she stated that the goal is to more than double employment in the construction sector from the current level of 360,000 jobs, and also cited investments in schools, road infrastructure, and public housing as potential projects under this program.

¶7. (SBU) Cabinet Chief Sergio Massa spoke to the press November 26 to clarify details of CFK's broad proposals. He said that the rapid deceleration of the Argentine economy was the main factor behind the economic stimulus package, and acknowledged that economic activity had fallen so far in the fourth quarter of 2008. (In a conversation with the Ambassador November 26, Foreign Minister Jorge Taiana confirmed that CFK was "extremely concerned" about the economic situation, both within Argentina and globally.) Nevertheless, Massa predicted that the fiscal stimulus through tax cuts and increased expenditures on public works would enable the country to sustain a 4% real rate of growth in 2009. (Comment: This compares to most economists' more negative forecasts, with estimates ranging from a 1-2% recession to growth of 3%.)

¶8. (SBU) He further commented that the new Production Ministry would "have as an objective the creation of a structure that defends exports, fortifies industrial and agricultural policies, and coordinate the different sectors to deepen the process of transforming Argentina and guaranteeing [high] levels of growth, employment, and economic activity." Regarding the tax moratorium on repatriated funds, he said "the measure will ensure that Argentines' savings, kept under mattresses, in safes, or overseas, will serve to promote Argentine growth." He discounted any possibility that it could be used to launder illicit funds, stating that the funds would have to be repatriated via banks and the GoA have strong controls in place to monitor the funds. (Comment: Numerous Argentine private analysts and opposition politicians have raised red flags about this measure. In addition to whitewashing plain vanilla tax evasion -- with one newspaper referring to it as "national tax evaders' day" --

several experts on money laundering and terrorism finance have argued that it could be abused by those looking to launder illicit gains.)

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Reason for Stimulus: Threats to Growth, Employment
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¶9. (SBU) Argentine industry, under growing pressure to cut back formal and informal employment in the face of rapidly declining consumer demand, has responded positively to the GoA's stimulus package. Industrial leaders had recently increased their public demands for government support, and in particular have been calling for the devaluation of the peso in response to the recent 30-40% depreciation of the Brazilian Real (Argentina's largest trading partner).

¶10. (SBU) Layoffs are anathema to the Kirchner administration formula that equates a strong, growing, and protected industrial sector with economic development. However, the GoA and Argentine Central Bank have also made it clear that they do not intend to allow a rapid depreciation of the peso, which would further exacerbate both inflation and the rapid capital outflow from the financial system over the last year that accelerated again recently following the President's October 21 announcement to nationalize the private pension system. Given this situation, the question under debate in the media has been how will companies, labor unions, and the GoA divide up the costs of minimizing firings, layoffs and suspensions in the face of forecasts of low to flat GDP growth or even recession in 2009. Clearly, the President's announced measures are designed to avoid the need for any layoffs.

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Markets React Positively, but Analysts Urge Caution
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¶11. (SBU) The government seems buoyed by the overall positive reception that its policy package has received so far. Beatriz Nofal, the head of the government's investment promotion board, told the Ambassador at an event late November 26 that CFK's announcement

contained "the most pro-business measures ever taken by either Kirchner government" since CFK's husband Nestor Kirchner assumed the presidency in 2003. Commerce Undersecretary Luis Maria Kreckler told the Ambassador that 40 Argentine businesspersons had accompanied CFK on her trip earlier this month to North Africa, and her exposure to them had encouraged her to adopt a more business-oriented outlook. Cabinet Chief Massa, who was reportedly the main architect of the measures, was similarly upbeat in his conversation with the Ambassador at the same event, asserting that "we're doing better."

¶12. (SBU) Local markets reacted positively on November 26 and 27 to the announcements. On average, Argentine bond prices increased 5-10% and the Buenos Aires Stock Market (MERVAL) jumped over 5%, and the peso depreciated only two cents, to close November 27 at 3.37 pesos/dollars. (Comment: Given the lack of detail provided so far about the President's proposals, it may be that investors are still digesting the news and that the price increases in Argentine assets actually reflect the recent rebound in global -- especially emerging -- markets.)

¶13. (SBU) Local and foreign analysts have reacted cautiously, preferring to wait for more details before making a final assessment. One of Post's closest banker contacts commented that CFK came across as "much more realistic and less arrogant" than in most of her speeches. Nevertheless, they have raised numerous questions about the potential positive impact of these various measures, with many arguing that it is unlikely the stimulus measures will actually arrest declining economic activity.

¶14. (SBU) With regards to the tax incentives to create jobs, analysts are skeptical that they will be sufficient to counteract the precipitous fall in demand and production. Regarding the incentives for repatriating funds, most analysts consulted by Post believe that investors hold deep concerns about the direction of the Argentine economy and the safety of investments in Argentine assets (following the recent example of the expropriation of private

pension assets). Given that capital flight from Argentina is estimated in the range of $22-24 billion for 2008, and over $4 billion just in October, the prevailing trend is going the opposite way. Nevertheless, some analysts have pointed out that many Argentines might take advantage of the opportunity to bring back funds legally that they likely never paid on taxes in order to invest in real estate.

¶15. (SBU) With regards to the public works program, most analysts believe it is too early to determine the impact. Still unclear is what the GoA will implement during 2009 and what it plans to implement over several years, and also unclear is whether the plan will incorporate all new projects, representing a true fiscal stimulus, or whether some of the public works projects may already be included in the 2009 budget. Finally, the most frequently heard question relates to how the GoA will pay for the program. Given that it has no access to credit and is facing the prospect of lower-than-expected revenues in 2009 due to the slowing economy and much-reduced international commodity prices for Argentina's agricultural exports, analysts note that the announcement of such an ambitious fiscal stimulus program has the potential to further destabilize Argentine markets that are already pricing GoA bonds at default levels.

Comment: Paying the Piper
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16 (SBU) In comparison with her sometimes combative rhetoric in the past, the President took a more realistic approach in these speeches, particularly in demonstrating her growing understanding of the need to work in collaboration with the private sector to address the tough economic times confronting the country. Nevertheless, he Kirchner Administration's base motivation for presenting these proposals is to save jobs in high-profile industrial sectors via a pump-priming recipe of tax credits and state-funded infrastructure development. Beyond attempting to staunch the immediate pain of a rapidly softening economy, these targeted measures also speak to the Kirchner administration's need to shore up its political base in advance of 2009 mid-term elections.

¶17. (SBU) However, given that a slowing economy and low international commodity prices for Argentina's agricultural exports will substantially reduce federal tax revenues in the coming year, analysts are right to ask from whence the billions to pay for this program will come. At a November 25 lunch the Ambassador held, a group of leading businesspersons and economists predicted the GoA would scrape together enough funds to meet 2009 spending and debt

payment needs. But the GoA certainly will not get funding from international capital markets, which remain largely closed for Argentine risk. And not from GoA bond purchases by domestic institutional investors, whose species has been exterminated by the nationalization of the private pension fund system.

¶18. (SBU) The likely GoA alternative is to use newly available resources captured from nationalized pension funds, along with recently augmented access to borrowing from Argentina's Central Bank and the largest state-owned bank, Banco Nacion. But it is as yet unclear that these additional resources will really suffice to finance both a large pre-2009 election spending pinata as well as meet GoA spiking debt obligations coming due in 2009 and 2010. If investors suspect that the GoA's spending plans will jeopardize its ability to service its debts, negative market reactions could overwhelm any positive stimulus effects, leaving companies, workers, and the government fiscal balance in an even more delicate state.

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